



ASIC

Australian Securities & Investments Commission

REGULATORY GUIDE 22

Directors' statement as to solvency

Chapter 3 — Internal administration (Part 3.5)

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From 5 July 2007, this document may be referred to as Regulatory Guide 22 (RG 22) or Practice Note 22 (PN 22). Paragraphs in this document may be referred to by their regulatory guide number (e.g. RG 22.1) or their practice note number (e.g. PN 22.1).

Headnotes

Directors' statement as to solvency; s301(5); statement is part of the accounts; obligations placed on directors; implications for auditors.

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Purpose

RG 22.1 This guide is issued for the guidance of directors and auditors of companies and their advisers. It replaces NCSC Release 326. The objectives of this guide are:

- (a) to clarify the status of the directors' statement required under s301 of the Corporations Law (Law);

- (b) to discuss the obligations placed on the directors in making the statement on the solvency of the company; and
- (c) to consider the implications for auditors.

Statement is part of the accounts

RG 22.2 The definition of “accounts” in s9 of the Law includes statements attached to or intending to be read with the profit and loss account or balance sheet. As s301(1) requires that a directors’ statement be attached to a company’s accounts, such a statement therefore falls within the definition of “accounts”.

Obligations placed on directors

Debts to be taken into account by directors in making the solvency statement

RG 22.3 The directors, when including their opinion on the solvency of the company in the directors’ statement under s301(5), are obliged to consider the company’s capacity to pay debts which it has incurred as at that date, rather than as at the end of the financial year.

RG 22.4 The Law does not directly specify whether, or to what extent, directors should take into account debts which will be incurred in the foreseeable future. The ASC considers that the words, “will be able to pay its debts as and when they fall due” introduce a prospective element into the statement. Accordingly, in forming their opinion, the directors should consider future debts to the extent that they will compete for payment with the debts existing at the date of the statement. The prospective period to be considered by the directors is not limited to the date of the subsequent directors’ statement, but the period up to that subsequent statement will be of significance to the directors’ opinion.

RG 22.5 Whether the directors have reasonable grounds for their opinion is to be decided on the basis of an objective test as stated by Mahoney JA in *Dunn v Shapowloff* (1977-78) 3 ACLR 775 at 783. It has also been held that, “unquenchable optimism” is not a reasonable ground of belief (*CCA v Daff* (1971-76) ACLC 28, 756). In addition, directors should be aware of the various sanctions for failing to make a proper statement, including s1308, False or Misleading Statements and s1309, False Information.

Matters to be considered by directors

RG 22.6 Directors should take reasonable steps to obtain all information relevant to forming an opinion in respect of this statement. Such steps form the basis of the defence to any breach of s1308 and 1309 of the Law (see para 5 above). Matters which could be considered include:

- (a) profit and cash flow budgets (the latter including, where appropriate, any repayments of loans where no fixed repayment dates have been stipulated);
- (b) the ability to realise current assets, particularly inventories and receivables;
- (c) the ability to comply with normal terms of credit;
- (d) the possibility of removal of financial support by major lenders; and
- (e) the material effect of any contingent liabilities.

These matters should not be seen as exhaustive.

RG 22.7 In addition to recording the resolution required by s303(2), it is desirable that the minutes record the basis upon which the resolution was made.

Qualified statements by directors

RG 22.8 The obligation of the directors pursuant to s301(5) is to form an opinion whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The statement may be qualified if there are material uncertainties. An example of such an uncertainty is the ability to renegotiate loans due for repayment. Directors should not qualify their statement when the circumstances do not warrant it. A qualified statement will not of itself operate to limit the liability of the directors, nor operate as a substitute for the proper discharge of their responsibilities.

RG 22.9 Situations may arise when the doubt over whether the company can pay its debts as and when they fall due becomes so great that it is not appropriate for directors to sign the directors' statement with a qualification. In these situations, the directors should make a negative statement stating that the company is unable to pay its debts as and when they fall due. It is not possible to state in precise terms when a qualification is no longer appropriate. Nevertheless, a qualification should not be an expression of hope or envisage an unlikely scenario. Commonly, the factor determining whether a company is a going concern

will be the existence of financial support from a bank or shareholder. For a qualified directors' statement to be appropriate, negotiations should at least be under way with a reasonable likelihood of placing the company in a position where it is able to pay its debts as and when they fall due.

RG 22.10 When a negative statement is made and a new debt is to be incurred, the directors should have regard to s592 of the Law which makes it an offence for a director to allow a company to incur a debt when at the time there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they fall due. The directors are also jointly and severally liable for the payment of the debt.

RG 22.11 A qualified or negative statement must be clearly worded and in sufficient detail for the reader to comprehend the statement fully. The statement should identify the item which is the subject of qualification and disclose monetary details where practicable. Where a qualified statement impinges upon the "going concern" assumption as the basis for preparing accounts, the directors should explain in the accounts their reasons for adopting the assumption in the light of the qualified statement.

Similarly, where directors state that there are reasonable grounds to believe the company will be able to pay its debts as and when they fall due despite prima facie indications to the contrary from the accounts, the directors should disclose the reasons for that opinion in order to ensure that the accounts disclose a true and fair view.

Implications for auditors

RG 22.12 Subsection 331A(1) provides, in part, for the auditor to report on the financial statements. The definition of "financial statements" in s9 of the Law means the "accounts" of a company. As the directors' statement is required to be attached to a company's accounts, the directors' statement is therefore regarded as forming part of the financial statements. It follows that the auditor is required to form a view as to whether the directors' statement complies with the Law.

RG 22.13 The auditor's duty to report on the financial statements does not require him or her to report on whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The auditor's duty pursuant to s331B(1)(b) is to form an opinion on whether the directors' statement is in accordance with the Law. In addition, the auditor has an obligation under s331D(a) to describe in the report any defect or irregularity in the financial statements. The auditor is therefore obliged to consider

the solvency statement and to provide such a description where there is reason to believe that a defect or irregularity exists.

RG 22.14 Attention is drawn to the issues raised in para 14 of the Statement of Auditing Practice AUP7, *Going Concern* (reissued May 1991), which states:

“Legislative requirements that members of the governing body formally state their representation on solvency as part of the financial information upon which the auditor reports, reinforces the need for adequate audit documentation. It should be recognised, however, that the auditor’s opinion on such a solvency declaration, although obviously linked to going concern considerations, will not always be identical to the auditor’s opinion on the appropriateness of the going concern basis. For example, an entity may be solvent in that it is capable of paying its debts as and when they fall due, but at the same time may not be a going concern because of an intention to liquidate or significantly curtail its operations within the relevant period. Conversely, while the going concern basis may be appropriate because of an entity’s intention and capacity to maintain the scale of its operations during the relevant period, there may be significant uncertainty concerning its ability to pay longer term debts as and when they fall due.”

In forming a qualified opinion, the auditor should specify the reasons and consider the applicability of s331E(2) of the Law.